Pulse.

2013

Depreciating Rupee & It's Impact on Auto Component Industry

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HIGHLIGHT

The auto component industry in India meets the raw material needs of the 2-3-4 wheelers. As per the industry estimates, approx. 60% of the total turnover is derived from sales to domestic OEMs, approx. 25% is from sales to replacement market and remaining 15% is exported. The industry offers a comprehensive product range. The industry is currently facing challenges at all fronts primarily due to slowdown in demand. The slowdown that started in the FY 2011-12 with decline in sales of Passenger Vehicles and Medium and Heavy Commercial Vehicles is now being experienced across the board in all segments including exports.

Indian Rupee has depreciated more than 22.5% since September 2011 creating a negative short term impact on the outlook of the industry and its survival. Although the news of revival in the US auto industry has kindled some hope for exports, still it seems currency volatility will negate the benefits. In a way, the downturn has caused a kind of spiral effect of decreasing demand due to rising fuel prices & inflation coupled with increasing raw material cost due to rupee depreciation and has squeezed both the top line and bottom line for the components manufacturers.

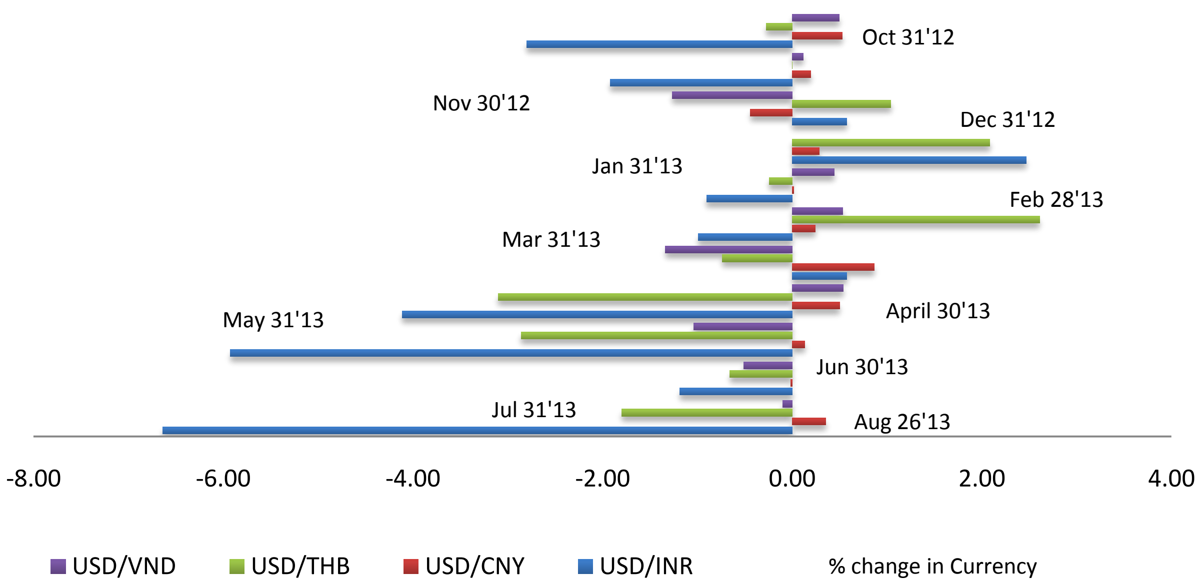
Many of the auto giants propose to start exporting the final products and localizing the production of imported auto components to minimize their losses. Exporting the automobiles will benefit the auto manufacturers in the present situation resulting from higher gains due to rupee depreciation; and in the long run it will help the economy to earn more foreign exchange. Both these measures are long run in nature and active participation of the private sector as well as adequate infrastructural support from the government is imperative to achieve this. Faster policy reforms and infrastructural support in the form of adequate power and energy, incentives to new enterprises, especially SMEs, easy allocation of land and land commercial-use rights, setting up of new SEZs are required from the government to promote the investment climate for the automobile industry.

Background

The Rupee Story

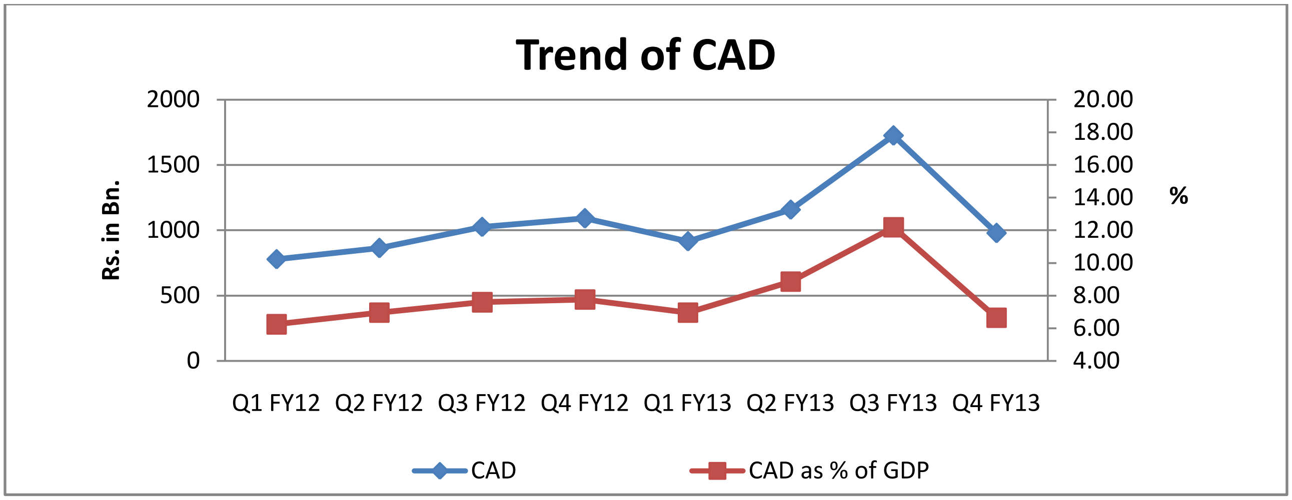
Indian Rupee has lost the maximum during the recent months against the US$ as compared to other currencies. Rupee depreciated by a whopping 22.5% over the one-year period from September 30, 2012. This has been a result of the major outflows of foreign exchange due to a resurgence of US$. The pull-out by foreign investors has been more on account of improvement in US economy and a low GDP growth rate in India during FY 13.

Trend of Various Currency Depreciation Against USD



VND: Vietnamese Dong CNY: Chinese Yuan THB: Thai Baht

The depreciation has a ‘spiral effect’ on the current account deficit (CAD). The CAD leads to pullout of forex leading to depreciation in the currency; the fall in the value of currency leads to increasing the cost of import, thereby increasing CAD. In simple words, India is a country which imports more that it exports. Thus the impact of depreciating rupee is translated in an overall increase in prices of most importee commodities and loss of competitiveness on the part of manufacturers.



Correlating the Currency Fluctuation & Cost of Automobiles

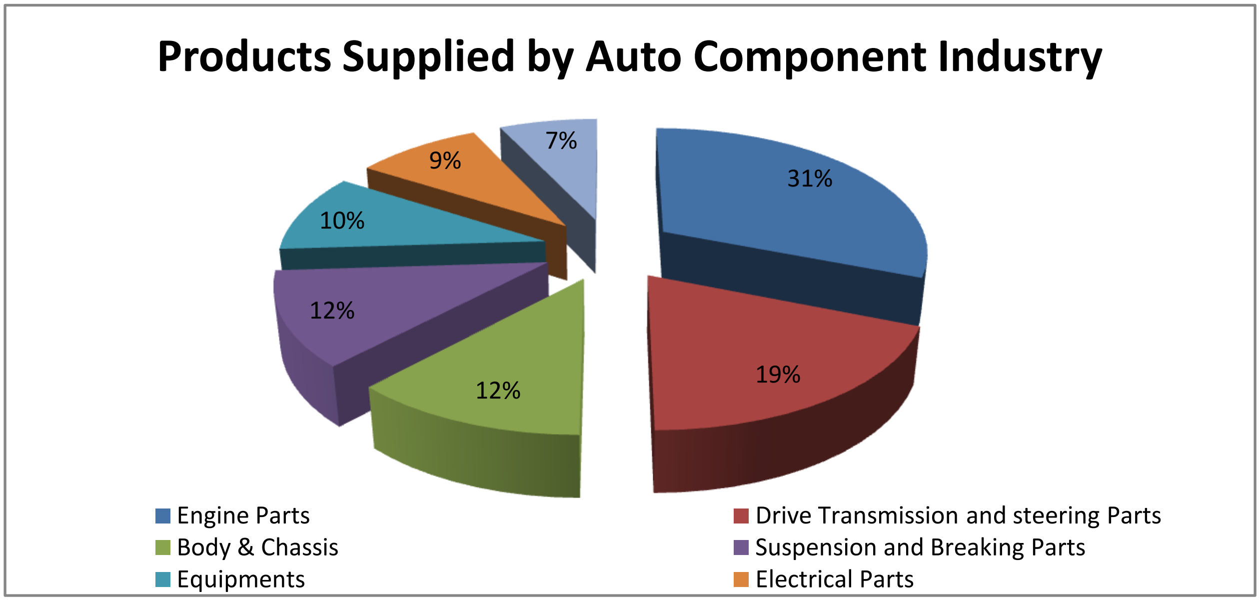
The Indian rupee has seen high depreciation against US$ in the recent past. The Automotive Component Manufacturers Association of India, reported that auto components worth $13.1 billion were imported in 2012-13. Such huge imports increase the demand of US$, thereby further weakening rupee. Subsequently, the prices of imported auto components go up. This squeezes the profitability margins of the auto component manufacturers and automobile manufacturers.

Two major raw materials – steel and coking coal are heavily imported. Though India has huge reserves of iron ore; the quality of the ore and coking coal impact the efficiency rate of extraction of iron and production of steel. Better quality iron ore and coking coal are imported and the landed cost of the raw material is quite high. An analysis by *Mint* underscored that the operating profit margins of a sample 45 auto component manufacturers has declined from 28.3% in FY12 to 15.7% in FY13. An increase in the prices of raw material will squeeze the margins of the auto component industry before being passed on to the buyers.

As the prices of auto components increase, the prices of automobiles increase. This has a negative impact on the demand of automobiles. According to the Society of Indian Automobile Manufacturers (SIAM), the automobile sector has already suffered a significant decrease in all the major segments in FY13 to register a growth of 1% (estimated values) as against a growth rate of 13.8% in FY12. First the heavy commercial vehicles, and then the utility vehicles and more lately the two-wheeler segment, the slowdown has hit the automobile sector and is expected, by the industry experts, to continue till the third quarter of the FY14.

Impact on Domestic Demand: The Vicious Circle

Increase in the cost of auto components resulting from depreciating rupee is not the only scuffle. A depreciating rupee also entails rising fuel prices, high inflation and a slowdown in the economy, with which the automobile industry has to wrestle. A slowdown in the economy is further characterized by decrease in the investments in any industry and decline in consumption. The demand for auto components is driven through the demand of automobiles.



Shrinking Demand Due To Rupee Depreciation

The elasticity of demand for auto components is not zero. Hence, as the prices increase the demand goes down. But there are multiple other factors which are equally important in contracting the demand for the auto components.

Increase in fuel prices

The value of rupee is inversely proportional to the fuel prices, India being a net importer of fuel. With the government taking initiatives to liberalize the fuel prices and remove subsidies, the cost of running an automobile goes up. As per a recent research paper, the cost of fuel prices is 10% of the total cost of running a small car in its first year. This splits the consumers of the automobiles from buying the car, especially at the entry level.

Debt Burden and Financial Coverage

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Exchange Rate	54.0	60.0	65.0	67.0
Principal Debt Obligation	100 USD	100 USD	100 USD	100 USD
Rate of Interest	L+3%	L+3%	L+3%	L+3%
Repayment Obligation	`	`	`	`
1 Year Loan	5670.0	6300.0	6825.0	7035.0
2 Year Loan	5953.5	6615.0	7166.3	7386.8
3 Year Loan	6251.2	6945.8	7524.6	7756.1

We note that the burden on the borrower and the foreign exchange reserves of India increase by 24.1% as the rupee depreciates from Rs.54/1 USD in Scenario 1 to Rs. 67.0/1 USD in Scenario 4. The above table is a simple example to illustrate the strain on the balance sheet of the auto component manufacturer as the rupee depreciates.

In a sample study conducted by a credit rating firm, approx. 37% of the total borrowings of the major auto components manufacturer were foreign currency dominated as on 31 March, 2013. Of these, approximately 25% of ECBs were un-hedged.

Inventory Pile Up

Coupled with economic slowdown and decrease in the real disposable income in the hands of the consumers, the demand of auto components shrinks while the raw material cost increases due to imports. This squeezes the margins of the automobile and auto component producers and has lead to many of the automobile manufacturers closing shop for a period.

Auto OEM	Days	Plant Sites
Mahindra & Mahindra	25/03/2013 -- 31/03/2013	Tractor plant at Jaipur and Rudrapur
Tata Motors	21/11/2012 – 26/11/2012 5/12/2012 – 7/12/2012 26/12/2012 to 28/12/2012	Pune
Bosch (Auto component)	28/06/2012 – 30/06/2012	Jaipur and Bangalore

Other major auto giants such as Maruti, Ford and Fiat have also been forced to consider such a decision in the wake of deteriorating conditions.

Analysis

Need is to aim for localization of components manufacturing and increased focus on exports

Many of the auto giants propose to start exporting the final products and localizing the production of imported auto components to minimize their losses. Exporting the automobiles will benefit the auto manufacturers in the present situation resulting from higher gains due to rupee depreciation; and in the long run it will help the economy to earn more foreign exchange. This will boost the ` Vs. $ equation. As per the data by Auto Component Manufacturers Association (ACMA), India is exporting auto components worth approx. 9.3 US$ bn. and is expected to grow to 12.0 US$ at a CAGR of 16% in FY13-21. Europe is the most favored export destination for the industry. Additionally, indigenous production of presently imported auto components will work in the same way to limit the outgo of the precious forex reserves and will boost the GDP growth in its own way.

Both these measures are long run in nature and active participation of the private sector as well as adequate infrastructural support from the government is imperative to achieve this. Faster policy reforms and infrastructural support in the form of adequate power and energy, incentives to new enterprises, especially SMEs, easy allocation of land and land commercial-use rights, setting up of new SEZs are required from the government to promote the investment climate for the automobile industry. This would not only promote investment from the private players for indigenous production of the presently imported components, but also make the industry more competitive.